



**MICHAEL J. MURPHY**  
*State Treasurer*

**Fourth Quarter 2003**

# The QUARTERLY

Local Government Investment Pool

## Employment: Last piece of the economic puzzle

The year 2003 appears to have been a period of transition. Weak economic data, combined with the war and other global shocks, dominated the first part of the year. Those were quickly forgotten as global economic conditions improved during the latter part of 2003.

Monthly economic data and the economists' spin on those data were closely examined, as was each Fed pronouncement. Investors reacted accordingly, based on the arguments they deemed most attractive. Consumer spending, housing, construction and other parts of the economic engine were on fire during the second half of 2003, with no signs of igniting inflation.

### Slack in labor

While many economists were optimistic about the prospects of further economic growth, others remained unconvinced. The lack of definitive growth in job creation was the primary reason for this discord. It was only during the last quarter of the year, when job growth showed strong improvement, that most investors concluded there was a positive sign that job creation was on its way to recovery. The unemployment rate had gone down from a high of 6.30 percent to 5.70 percent by the end of 2003. However, this optimism was short-lived as an anemic December non-farm payroll report came in well below expectations. In fact the retail sector, which had been performing well, shed 38,000 jobs during the most important shopping season of the year. This explained why most retailers were not very enthusiastic about their sales targets and content to say that sales were "within their expectations."

Additionally, the manufacturing sector continued its slump, shedding another 26,000 jobs in

December. Throughout 2003, investors heard reports of manufacturing plants being moved overseas to trim costs. News of high value-added jobs being exported elsewhere served to further exacerbate the growing tension in the local job market. In an effort to protect domestic jobs, the Bush administration even implemented trade tactics.

Economists, in an effort to explain the inconsistency of reports showing a lower unemployment rate and at the same time a very low job creation rate, attributed it to the changing landscape of the labor force. The official data did not capture the sharp rise in low-wage unemployment and underemployment. The numbers that showed the biggest increase in hiring for December came from temporary hiring and self-employment. Self-employment became significant after many of those out of work exhausted their unemployment checks which, according to some analysts, was the result of a lackluster labor market. While these may be credible explanations, they could not hide the fact that, until the end of 2003, there was still a large amount of slack in labor.

### The asynchronous economy

The Federal Reserve had clearly expressed its view that it would leave rates low for a "considerable period" of time, even if economic growth accelerated, since it did not see the threat of inflation. The impressive economic performance of 2003 assuaged investors' fear of a no-recovery scenario but did not soothe investors' concern that signs of growth might not be sustainable.

Strategists and investors alike were unclear whether economic numbers were only smoke

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## Market summary

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signals of a feeble economic recovery, or the real upturn they were hoping for after three years of painful economic decline. Throughout 2003, economic indicators were inconclusive in ascertaining sustainable growth.

On the surface, the economic performance of the U.S. was impressive relative to the global economy. The U.S. Gross Domestic Product (GDP) growth exhibited signs of strength, productivity was at its highest point, inflation was negligible, and export numbers were rising. Corporations expressed a desire to increase both capital spending and hiring. The stock market reflected the U.S. economic performance with remarkable gains of roughly 28 percent for the Dow Jones Industrial Average and the S&P 500 indexes, while the NASDAQ skyrocketed by 50 percent year-over-year gains. It seemed as though the "Goldilocks" economy that the U.S. had been accustomed to during the late 1990s had been resurrected from its early demise.

However, there was much criticism that the country's growth performance was due to "steroids" which could worsen the already large structural imbalances in the U.S. economy. Growth was aided by two rounds of stimulative tax cuts, the low interest rate environment, and depreciation of the U.S. dollar. Tax cuts and the low interest rate environment fueled consumer demand for goods and services. The housing sector continued its ascent due to sharp declines in interest rates. Mortgage refinancing became the most convenient and popular way to open the cash spigot for homeowners. The down side was the significant rise in consumer debt brought by easy money. Economists warned that higher consumer debt levels could derail the country's economic momentum if not corrected in the near future, especially if the Fed should tighten interest rates.

Another catalyst in the country's economic momentum was the dollar's decline, which made U.S. exports attractive. The dollar declined significantly against major trading partners, Europe and Japan. It fell almost 17

percent versus the euro, and 11 percent versus the yen for 2003. As a consequence, the U.S. trade deficit shrank to \$38 billion in November and exports recorded a 3-year high. The narrowing of the country's trade deficit reflected the inroads made by the cheaper dollar in the global market.

The dollar depreciation had an even more positive effect on the U.S. economy. Because many other countries were defending their currencies from appreciation, fearing their exports would become unattractive in the global market, capital inflows from rich Asian exporting nations found their way to the U.S. Treasury. Anecdotal comments during the year-end rally suggest Japan was buying U.S. treasuries to prop up the yen's value. The recycled capital helped maintain a low interest rate environment.

There was a concern that the country's rising budget deficit would push up interest rates and "crowd out" private businesses. The government repeatedly warned that more money was needed to fight the war on terror, which would translate to more debt issuances in order to finance the record budget deficit. Wall Street analysts estimated almost \$800 billion U.S. Treasury note sales would be necessary to finance a \$500 billion deficit by the end of the third quarter of 2004. Fed Chairman Alan Greenspan calmed investors' nerves by saying "there is little evidence of stress in funding U.S. current account deficits largely due to the fact that there is deeper integration of trade and the financial markets."

The Federal Reserve, during its December meeting, shifted to a "balanced" growth outlook and hinted inflation would remain low for a long time. In December the CPI recorded a year-over-year change of 1.11 percent, a 40-year low. The Fed's policy accommodation stance was implied when several Fed governors explained that the output gap would remain wide due to slack in resource utilization and relatively benign inflation.

The Fed's main concern was the sustainability of the labor market growth more than inflation risks, since it believed slack in resource

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## Market Summary

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utilization and high productivity would hold inflation steady. Fed Governor Bernanke pointed to the fragile labor market as the key reason the Federal Reserve must maintain its accommodative monetary policy.

The bond market performed well during the final quarter of 2003 due to cash seasonality and the generally bearish view of bond investors. Domestically, most bond managers were short their duration bogeys, which was exacerbated by fresh infusions of cash. Demand for U.S. Treasury bonds from Europe, Japan, and China also helped pushed the bond yields to their October lows. These purchases by foreign accounts were attributed to the need to protect respective currencies and natural demand for U.S. assets.

Because most investors were short the market, it was easy to push yields down near their October lows. As shown in the graph on page 8, over the last quarter yields on 3-month and 6-month bills were down by 6 and 7 bp, respectively. The 2-year note yield was 14 bps lower and 3-year notes fell 15 bps. The 5-year, 10-year, and long-bond rallied with lower yields losing 18 bps, 24 bps, and 25 bps, respectively.

During the last quarter of 2003, while the targeted fed funds rate remained at 1 percent, the net return on the LGIP held steady at 1.07 percent. However, the longer fed funds stay at 1 percent the more difficult it becomes to keep the LGIP above that rate. Market analysts and fed funds futures indicate the Fed will hold the targeted rate at least through the first half of the year. The average life of the LGIP is neutral at 50 days. The portfolio is positioned to shift accordingly with any changes in market sentiment.

### What does 2004 hold for investors?

Looking ahead at 2004, most economists present an even rosier economic picture. The median forecast for the country's GDP is around 4.4 percent, while the unemployment rate is expected to fall to 5.7 percent. Judging from the strong economic data released during the last half of 2003, there are reasons to

believe the U.S. economy will perform much better this year. Early signs of healthy inventory replenishment and better corporate hiring outlook indicate the economic momentum may be continuing.

Consumer confidence has lifted business confidence which, in turn, could generate a multiplier effect necessary for economic growth. Sustainable job creation is the only missing component to confirm the economy's growth momentum in 2004. Most strategists believe it is premature to talk about the possibility of interest rate hikes.

Employment data, labor costs, inflation, and productivity are the crucial indicators for investors to watch in 2004. Monthly payroll numbers will likely be the most important piece of the picture. Economists believe net hiring will eventually improve if the U.S. economy can translate momentum in the fourth quarter of last year to a sustainable growth rate. Due to higher productivity, corporations have been able to keep costs down, which has translated into better corporate profits. There is hope that the rise in corporate earnings will give impetus to higher capital spending and hiring in 2004.

There is a growing consensus that the bond market will be in a trading range for the first half of 2004 and, depending on the country's economic performance, may experience a breakout in the second half of the year. Most strategists discount the possibility of any rate hike in the first half of 2004. Fed funds futures currently suggest a small probability of a rate hike by the end of this year, a wide departure from earlier expectations of a hike by the middle of the year. With so many diverging views, investors should expect a volatile market in 2004.

The outlook for the LGIP in the coming year depends heavily on the Fed. Given that all current indications show the targeted fed funds rate remaining unchanged for at least the first half of the year, participants should expect to see the LGIP net rate at, or very near, 1 percent. Should the Fed raise or lower the targeted funds rate, the LGIP will follow that trend, slightly lagging the change.

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## Investing 101: A history lesson

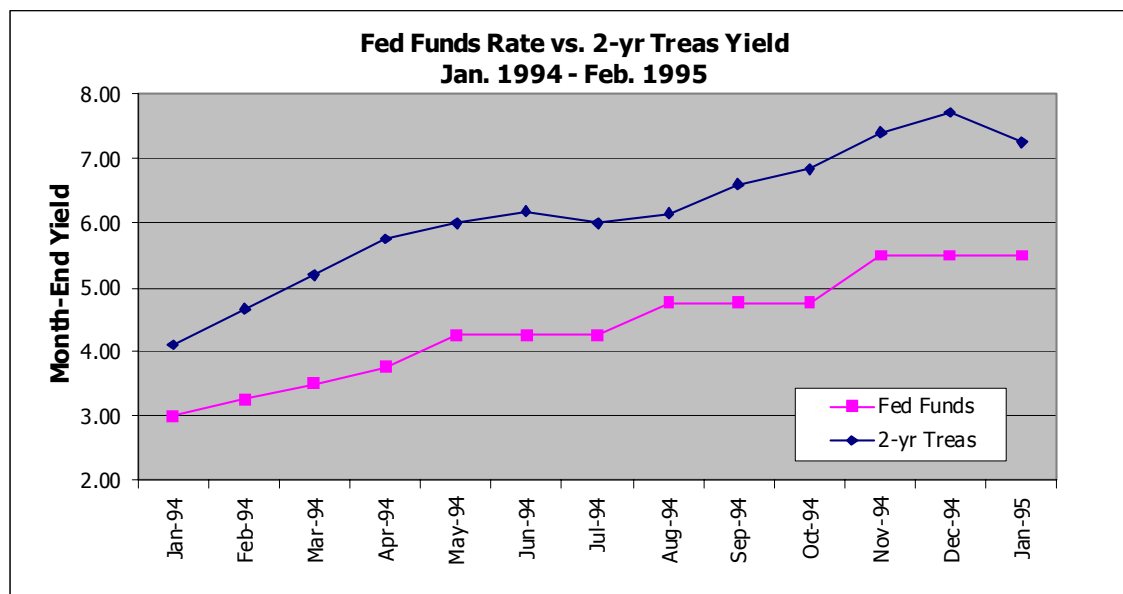
The following article is part of the "Investing 101" educational series, which focuses on basic investment issues. We hope you find these articles informative and helpful.

As we ring in 2004, the targeted fed funds rate remains at a historical low of 1 percent. And, for the past 17 months, the yield on 2-year treasury notes has lingered at unprecedented low levels between 1.05 percent and 2.30 percent. These record low returns place heavy burdens on many budgets. In addition, uninvested cash accumulates as maturities occur and portfolio managers delay investing out the curve, waiting instead for higher interest rates.

Portfolio managers may feel pressured to maintain earnings at levels achieved in previous years, even though current market yields are historically low. The risk then, is for managers to succumb to those pressures and begin "reaching" for yield, buying products, maturities, or maintaining an average maturity that they would ordinarily shy away from. This risk becomes even greater the longer yields remain at such low levels. Further, the sense of relief when rates finally begin to increase, combined with pent-up cash, often tempts portfolio managers to abandon their usually disciplined investment decisions in an effort to increase the portfolio yield. In this article we'll discuss the importance of considering history when making investment decisions and the value of maintaining discipline within your investment program. While there are many lessons we can learn by studying historical trends, here we focus on some potential risks associated with investing in a low interest rate environment.

Past history is not a guarantee of future performance – a prospectus from any bond mutual fund will tell us that. This is true of interest rates as well, and while no one can forecast interest rates, history can provide some useful insight. History clearly reveals the potential risks during the early stages of a rising rate environment when yields begin to increase after a prolonged period at low levels. It is during this phase that many portfolio managers have suffered significant losses with disastrous consequences, all attributed to overly aggressive and undisciplined investment strategies.

To illustrate these risks, let's look at an example of an extended period of relatively low interest rates and the effects of an improving economy and Fed tightening. In February 1994, when the targeted fed funds rate had been at 3 percent for 16 months, the Fed began a tightening cycle. In the 12 months from February 1994 to February 1995 the targeted fed funds rate rose 300 basis points (bp), from 3 percent to 6 percent. As fed funds moved higher, so did yields on fixed income securities. The graph below compares the fed funds rate to the yield on the 2-year treasury note during that time period:



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## Investing 101

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Note the pattern of the fed moves. The fed tightened several times during that time period, starting with 25 bp intervals, proceeding to 50 bp moves, and even one tightening of 75 bp in November 1994. History shows this is a fairly typical pattern. Therefore, one would expect that when the fed begins to tighten, there will likely be a series of moves rather than a single occurrence.

Another observation we can draw from this example is the manner in which the market anticipates moves by the Fed. This is reflected in the yields of longer term securities, like 2-year treasuries. The spread between the targeted fed funds rate and the 2-year treasury averaged 101 bp during the 12-month period preceding the first tightening. During the remainder of 1994 the spread averaged 178 bp and spent a good deal of time in excess of 200 bp. In other words, the yields on 2-year treasuries rose more sharply than the fed funds rate and were also more volatile. Again, history will show this to be a typical pattern.

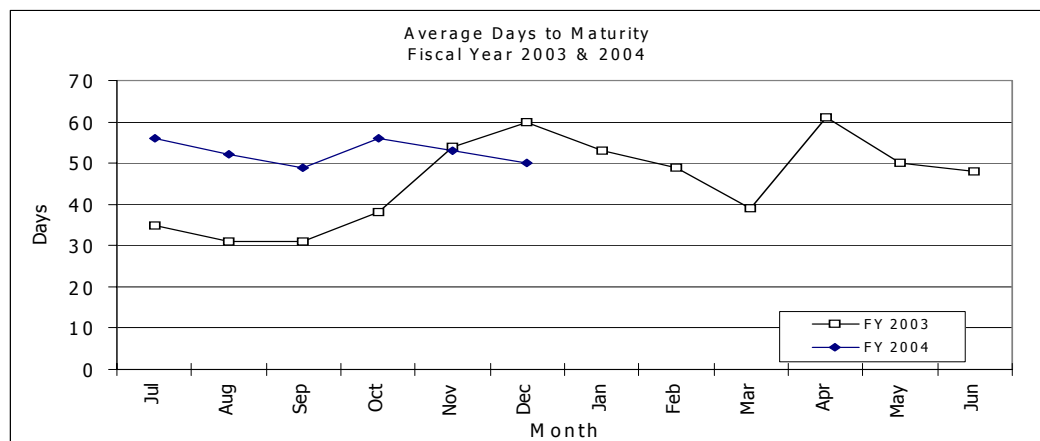
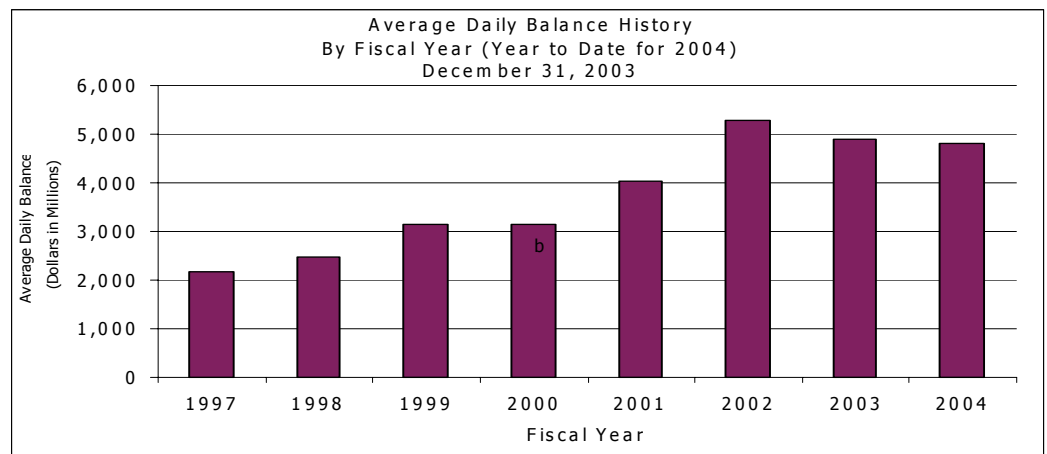
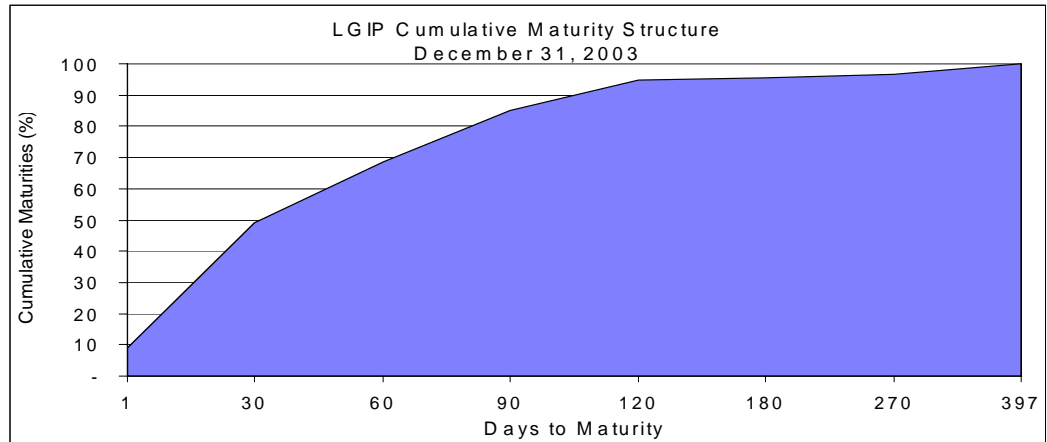
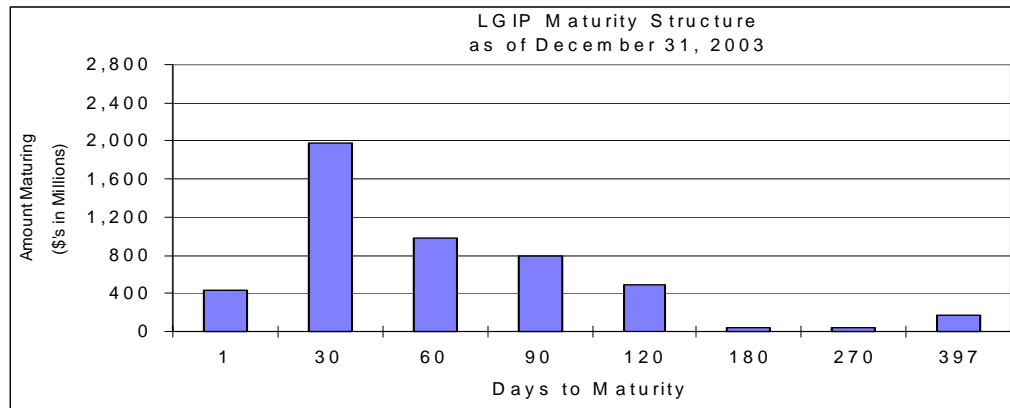
When yields begin to rise, especially after extended periods at very low levels, managers may be tempted to invest immediately in longer-term products, grasping for higher yields. This was not a winning strategy in early 1994. By the end of March 1994, the 2-year yield had increased by over 100 bp to 5.19 percent. During that same two-month time period fed funds had increased by 50 bp, from 3 percent to 3.50 percent. While this might have looked attractive at the time, an investment in the 2-year security just two months into the tightening cycle would have underperformed a much shorter investment. A better strategy would have been to remain in short-term products, like the LGIP, until later in the year and then investing out the curve. However, hindsight is 20/20; it's easy to look at history and pick out the best strategy, but no one can forecast what rates will be in the future. The main point of this example is the importance of maintaining discipline in your investment program, as opposed to adopting aggressive strategies based solely on the current market environment.

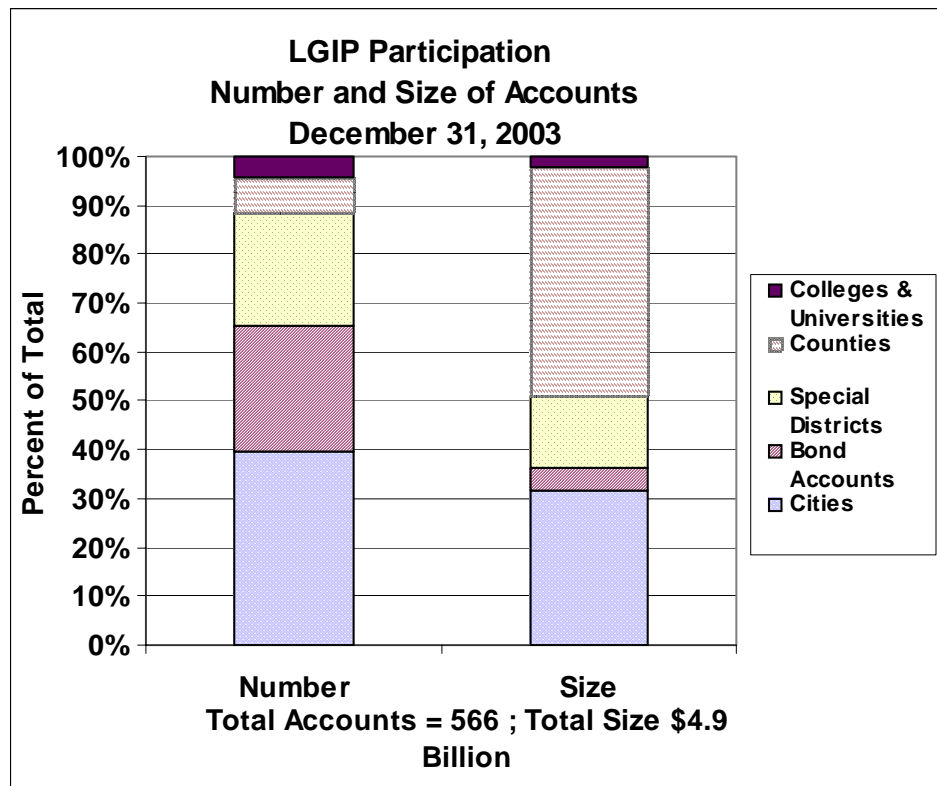
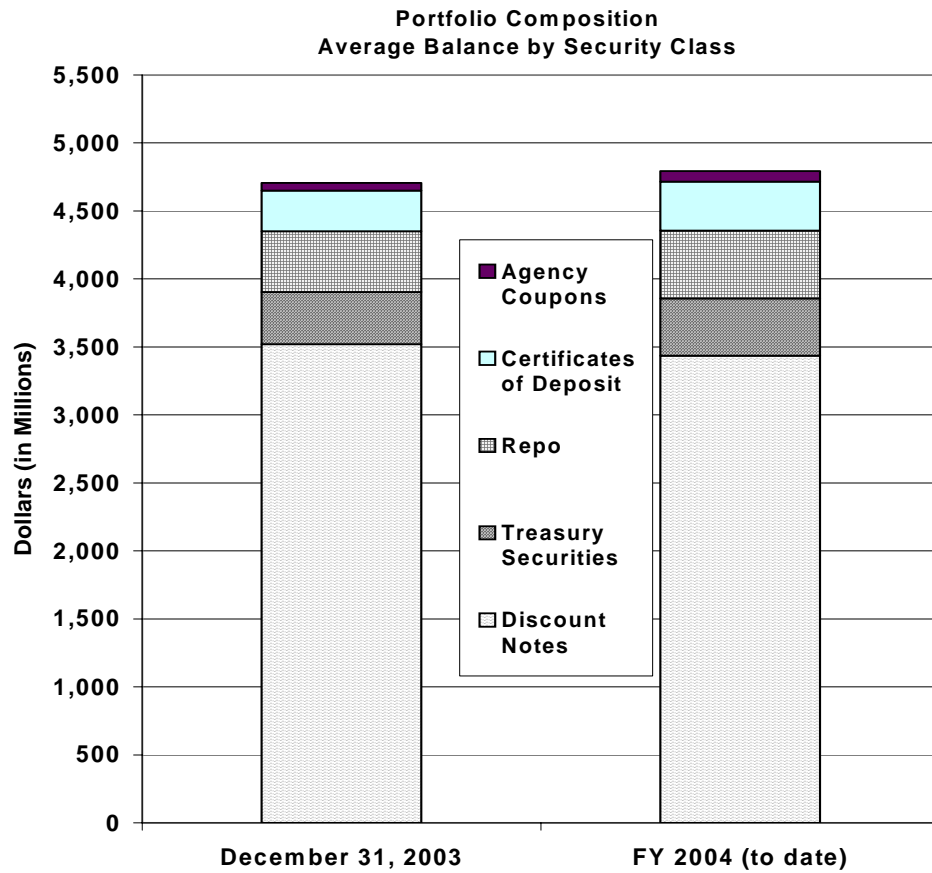
What is the risk of this "reaching" for yield or not maintaining discipline in your investing? Certainly there is opportunity loss, i.e., your portfolio may have performed better had you invested less aggressively, or maintained its average life back in 2001 when rates dropped to levels that, at the time, were considered too low. But perhaps the greatest risk is the potential need to liquidate holdings that are significantly under water due to rapidly rising rates. Not only would you suffer loss of principal, you would also be in direct conflict with the safety, liquidity and yield objectives of your investment program. And even if you are not actually forced to liquidate securities at a loss, in accordance with GASB 31 those paper losses must be included on the balance sheet.

Considering the current interest rate environment and what we've learned from our example, what can we conclude regarding future interest rates? Targeted fed funds have been at 1 percent since June 2003. Currently, the rate is expected to remain unchanged. While there is always the possibility of lower rates, most likely the next Fed move will be a tightening. Will you be tempted to aggressively pursue higher interest rates on longer-term products early in the tightening cycle? Or will you maintain a more disciplined approach, adhering to your investment policy?

The current interest rate environment and recent comments by the Fed emphasize the importance of developing a thorough investment policy that covers the risk tolerance of the entity. To minimize risk, the policy should address maximum and average maturities for the portfolio. Keep in mind there is no universal maximum and average maturity. Those parameters will vary from entity to entity, as they should be a function of the nature and certainty of cash flows, as well as the experience of the portfolio managers and the risk tolerance of the oversight board.

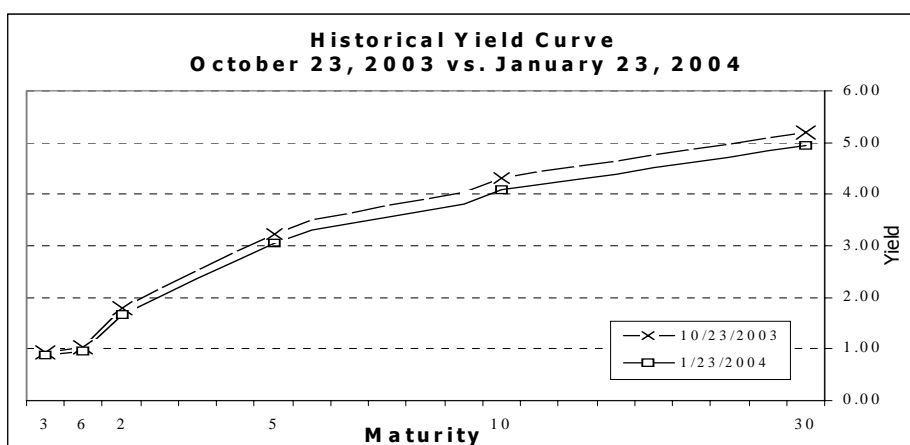
Our history lesson has shown that we can minimize risk by keeping a historical perspective. But our most valuable lessons are the importance of a sound investment policy that clearly addresses risk tolerance, and maintaining discipline when making investment decisions.





## Market Summary

from page 3



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### Notes from the January 23 LGIP advisory committee meeting

The LGIP Advisory Committee met January 23. A brief update was given on the net LGIP returns for January through December 2003. The fed funds rate remains at 1 percent, and it is anticipated this rate will stay at 1 percent for the next six months or possibly longer. The LGIP has outperformed its benchmark by an average of 43 basis points for calendar year 2003. The net rate of return for the LGIP from January to December 2003 was 1.1635 percent whereas for iMoneyNet, Inc, the net rate of return was 0.7315 percent.

The strategy for the management of the LGIP portfolio was discussed. Currently, the portfolio has an average life of 45-55 days, reflecting a neutral position. Advisory committee members discussed their investment strategies and general market conditions.

A handout was distributed to committee members describing the balance activity in the LGIP. The first chart shows daily balance activity during a typical month. The second chart shows the balance activity for Fiscal Year (FY) 2004 to date, and the third chart indicates the balance activity over several fiscal years as well as the growth of the Pool from FY 2000 to FY 2004.

The FY 2004 budget was reviewed utilizing a handout provided to committee members. Through November 2003, the fees and overdraft charges of \$716,829 were \$131,829 higher than the preliminary estimate. This is attributed to higher than expected balances in the LGIP. Actual expenses through November 2003, of \$241,238 were \$9,595 below the original estimate. Adjusting for actuals, the estimated rebate of \$802,000 for FY 2004 has now been increased by \$141,424 to \$943,424.

Bank of America is implementing a new wire transfer system and will be utilizing a new routing/transit ABA number for all wire activity effective February 9, 2004. A letter was mailed on January 9 to LGIP participants notifying them of the new ABA number change.

A new procedure will be implemented for colleges and universities to pay their debt service payment. The payments may now be made from the college's LGIP account, which will eliminate wire transfer costs.

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### LGIP Holiday Schedule for 2004

The Local Government Investment Pool will be closed on the following days:

Monday	February 16	President's Day
Monday	May 31	Memorial Day
Monday	July 5	Independence Day
Monday	September 6	Labor Day
Monday	October 11	Columbus Day
Thursday	November 11	Veteran's Day
Thurs/Fri	November 25-26	Thanksgiving holiday
Friday	December 24	Christmas
Friday	December 31	New Year's



**Washington State Local Government Investment Pool**  
**Position and Compliance Report**  
**as of 12/31/2003**  
**(Settlement Date Basis)**

**LGIP Portfolio Holdings**

	<b>Cost</b>	<b>Percentage of Portfolio</b>
Agency Bullets	\$ 59,424,941	1.20
Certificate of Deposit	100,650,000	2.04
Discount Notes	3,720,335,964	75.31
Interest Bearing Bank Deposits	180,907,448	3.66
Repurchase Agreements	510,903,000	10.34
U.S. Treasuries	267,680,558	5.42
U.S. Treasury Bills	99,944,972	2.02
<b>*Total Excluding Securities Lending</b>	<b>4,939,846,883</b>	<b>100.00</b>

**Securities Lending Holdings**

Repurchase Agreements	154,350,330
<b>Total Securities Lending</b>	<b>154,350,330</b>

<b>Total Investments &amp; Certificates of Deposit</b>	<b>\$ 5,094,197,213</b>
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**Policy Limitations**

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.\**

**Size Limitations**

	<b>Portfolio Holdings</b>	<b>Percentage</b>	<b>Policy Percentage</b>
Certificate of Deposit	100,650,000	2.04	10%
Leverage - Sec Lend + Rev Repo	152,949,229	3.10	30%

**Maturity Limitations (Days)**

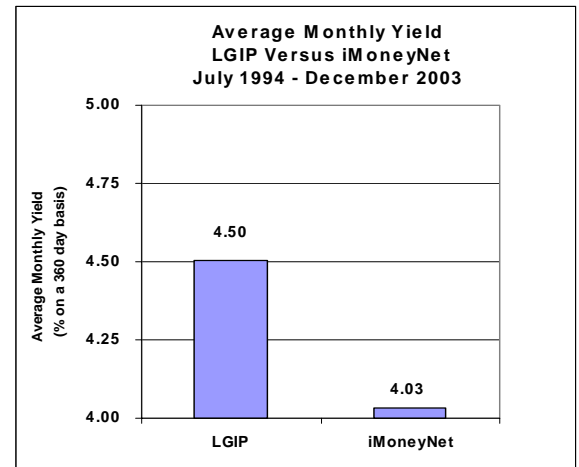
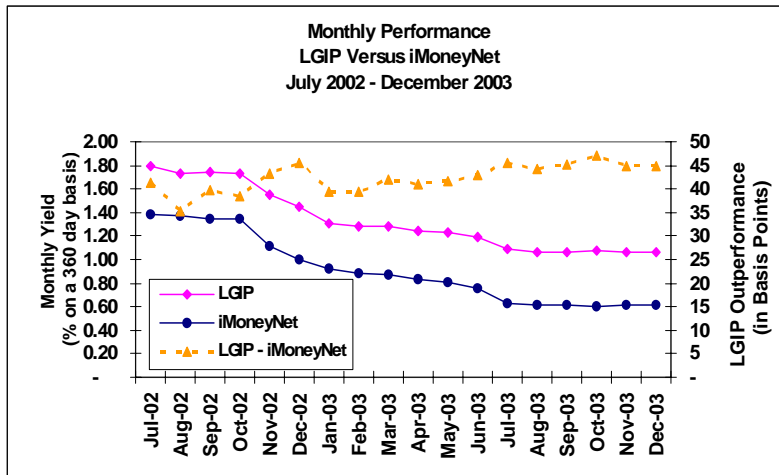
	<b>Currently</b>	<b>Policy</b>
Average Life	50	90
Maximum Maturity	366	397
Maximum Maturity of Repos	14	180
Maximum Maturity of Reverse Repos	0	90

**Repo Limits Per Dealer**

	<b>December 31, 2003</b>	<b>Total Repo Percentage (20% limit)</b>	<b>Term Repo Percentage (10% limit)</b>	<b>Projected Redemptions 1/2/2004</b>	<b>Projected Position 1/2/2004</b>
Banc America Securities	\$ 100,000,000	2.02%	0.00%	100,000,000	-
Bear Stearns & Co.	200,000,000	4.05%	4.05%	-	200,000,000
Goldman Sachs	154,350,330	3.12%	0.00%	154,350,330	-
Lehman Brothers Inc.	210,903,000	4.27%	0.00%	210,903,000	-
<b>Total</b>	<b>\$ 665,253,330</b>			<b>465,253,330</b>	<b>200,000,000</b>

# LGIP Performance Comparison

## iMoneyNet, Inc.<sup>1</sup> versus Local Government Investment Pool



The chart on the left shows a monthly comparison from July 2002 through December 2003 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to December 2003. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 47.1 basis points. This translates into the LGIP earning \$145.28 million over what the average comparable private money fund would have generated.

<sup>1</sup> Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

# Local Government Investment Pool

## STATEMENT OF NET ASSETS

December 31, 2003

### Assets

Investments, at Amortized Cost:	
Repurchase Agreements	510,903,000
U.S. Agency Coupons	59,424,941
U.S. Agency Discount Notes	3,720,335,964
U.S. Treasury Securities	367,625,530

#### Total Excluding Securities Lending

& Securities Purchased But Not Settled 4,658,289,435

Securities Lending Investments, at amortized cost:

Repurchase Agreements	154,350,330
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#### Total Investments (Settlement Date Basis)

4,812,639,765

#### Total Investments (Trade Date Basis)

4,812,639,765

Interest Bearing Bank Deposits	180,907,448
Certificates of Deposit	100,650,000
Interest Receivable	2,818,534

#### Total Other Assets

284,375,982

#### Total Assets

5,097,015,747

### Liabilities

Cash Drawn in Excess of Bank Balance	789,387
Accrued Expenses	134,268
Obligations under Securities Lending Agreement	154,350,330
<b>Total Liabilities</b>	<b>155,273,985</b>

### Net Assets

\$ 4,941,741,762

Participant Net Asset Value, Price per Unit

\$ 1.00

Total Amortized Cost - Settlement Date Basis \$ 5,094,197,213

## QUARTER AT A GLANCE

October 1, 2003 to December 31, 2003

Total investment purchases:	\$ 24,125,052,725
Total investment sales:	\$ 1,649,644,094
Total investment maturities:	\$ 22,344,682,000
Total net income:	\$ 13,589,993
Net of realized gains and losses:	\$ 415,718
Net Portfolio yield (360-day basis):	

October	1.0734%
November	1.0694%
December	1.0698%

Average weighted days to maturity: 50 days

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